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SUBJECT: RENEWED DEBATE ON DOLLARIZATION IN HONDURAS, BUT
GOH POLICY UNLIKELY TO CHANGE ANY TIME SOON

11. (SBU) SUMMARY. Liberal Party congressman and businessman Jaime Rosenthal Olivia and banker Jorge Bueso Arias have renewed their appeals for dollarization in recent weeks. The two bankers argue that replacement of the lempira with the dollar would help increase capital investment and lower interest rates. They claim the GOH has used gradual depreciation of the lempira, the Honduran national currency, as a tax on the public to generate revenue. GOH officials have downplayed the issue, simply commenting that the preconditions for dollarization do not exist in Honduras. The leadership of the Congress has agreed to hold hearings at Rosenthal's request but there are no plans in the legislature to push for dollarization either. End Summary.

Rosenthal's Complaint is With the Exchange Rate Policy

12. (SBU) Jaime Rosenthal Olivia, Secretary-General of the Liberal Party (PL) and a private businessman with banking interests, renewed his public calls for dollarization in early October. Rosenthal's key concern appears to be the Central Bank's policy of gradual depreciation (currently five to six percent annually) designed to maintain purchasing power parity with the U.S. and competitiveness of Honduran exports. Jorge Bueso Arias, president of Bank Occidente and an active member of the Liberal Party, has expounded upon Rosenthal's argument. Bueso Arias terms the exchange rate policy, in which the lempira has lost 26 percent of its value since 1998, as a tax on average Hondurans. Bueso Arias believes that if the GOH keeps devaluing the lempira, it would be better to dollarize.

13. (SBU) Rosenthal terms the steady depreciation of the lempira as instability that undermines Honduras' economic development. He argues that dollarization, by eliminating currency risk, would increase foreign and domestic investment. He asserts that dollarization would lower the risk premium for investments in Honduras and result in lower interest rates and inflation. He also claims that dollarization would increase remittances and reduce capital flight (which he discusses in terms of Hondurans who protect the value of their savings by converting their lempiras into dollars). The bankers' arguments imply they believe that dollarization would lead to more sound fiscal policies.

14. (SBU) Comment: There are a number of apparent fallacies in Rosenthal's argument. The GOH has instituted its exchange rate policy purposely in order to avoid pressures that would result in a sudden devaluation of the lempira and a financial crisis. Hondurans are able to both save and lend in dollars or lempiras, so there is no impetus toward capital flight or a disincentive to the sending of remittances (which have been growing at a high rate since 1998). The high interest rates and limited availability of medium and long term loans are related to country risk, problems in collection of loans, and the weakness of the banking sector (there have been several bank failures in recent years); currency risk appears to play a small role. The Central Bank has brought inflation down steadily since 1999. Because of Honduras' high indebtedness, the government is restricted in its ability to print money to finance deficits. Finally, the Liberal Party contingent of the Congress has been a major impetus for the populist, budget-busting legislation which has caused the government's intractable fiscal problems. Dollarization would not fix this. End Comment.

The GOH - Honduras is Not Ready

15. (SBU) GOH officials in the Maduro administration, just like their predecessors in the Flores government, have downplayed the proposal, explaining quietly that Honduras is not in a position to dollarize at this time.

16. (SBU) Maria Elena Mondragon, president of the Central Bank

of Honduras, and Ana Cristina de Pereira, president of the National Commission of Banking and Insurance, have noted that the country must lower inflation and the fiscal deficit to U.S. levels before dollarization can be considered. Mondragon also has noted to the press that international reserves equal four months of imports, reducing the risk of an abrupt devaluation. Mondragon also said that dollarization will not solve the country's economic and financial problems. Cristina de Pereira has explained to the press it would take at least five years for the country to make the necessary economic structural reforms before the country can dollarize.

17. (SBU) President Ricardo Maduro has commented publicly that while Central America is on the road to dollarization, Honduras is not ready. He has been clear that the GOH will not pursue dollarization during his four-year administration.

USG Official Neutrality

18. (SBU) Per U.S. policy, Embassy officials will not take a position on dollarization if asked. EmbOffs will point out that this is a decision for the government of Honduras to make, after balancing the pros and cons. If in the unlikely event that GOH officials ask our advice, Post will refer the inquiries to the Treasury Department.

19. (SBU) Comment: The Embassy does share the GOH's assessment that the preconditions for dollarization do not exist in Honduras at this time. The GOH has not achieved fiscal stability (fiscal deficit exceeded six percent of GDP in 2001). Inflation is declining but is still far higher than U.S. inflation rates, resulting in the need for gradual depreciation to avoid making exports uncompetitive. The financial system is fragile, and despite improved supervision under the Maduro administration, much remains to be done. Exchange rate reserves, at about four months worth of imports, are adequate but not sufficient to ward off a financial crisis. To date, we have not seen clear political commitment and civil society support for the types of structural reforms that would make dollarization feasible. Without these conditions in place, dollarization would lead to greater economic stagnation and unemployment because of the inability of the economy to adjust to external shocks. End comment.

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